NOTES

THE TRUST CORPORATION: DUAL FIDUCIARY DUTIES AND THE CONFLICT OF INSTITUTIONS

INTRODUCTION

It is sometimes the desire of a testator to employ shares representing a controlling interest [1] in a corporation as income-producing properties of a trust.[2] To accomplish this, he may direct that control of the corporation be exercised by the trustee as a director, with the voting power of the trust shares being used for self-election.[3] In such a context there arises a duality of fiduciary duties in the same individual. Although the legal rules surrounding both positions contain prohibitions against conflict of interests,[4] this particular situation—often considered desirable for purposes of trust administration—is usually permitted to exist.[5] In 1937 Edmond N. Cahn, writing in this *Review,* stated that "in such case, it remains the duty of the trustee-director to adhere to that standard of conservatism and prudence which the interests of his trust demands." [6]

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[1] The trust—itself or combined with the individual holdings of the fiduciary—may own all or a majority of the voting shares of the corporate stock, or may, through dispersal of the shares, have working control without an actual majority. In formulating the rules which determine fiduciary responsibility, some courts and commentators have in the past drawn distinctions based on degree of control. See In the Matter of Estate of Adler, 164 Misc. 544, 299 N.Y. Supp. 542 (Surr. Ct. 1937); In the Matter of Estate of McLaughlin, 164 Misc. 539, 299 N.Y. Supp. 559 (Surr. Ct. 1937); Moll & Silverman, *Closed Corporations and Some Related Problems of the Fiduciary,* 19 N.Y. CERTIFIED PUBLIC ACCOUNTANT 609 (1949); Note, *Trusts —The Fiduciary Aspects of Estate Corporations,* 57 MICH. L. REV. 738 (1959). However, it is submitted that such differences are not material; the outside interests appearing in varying degrees in each of these situations require application of a consistent principle for their protection.

[2] While the term "trust corporation" is used herein, no distinction is intended from a corporation the shares of which are held by a fiduciary as part of an estate rather than an express trust; such a distinction is not material. See 3 BOGERT, TRUSTS & TRUSTEES § 572, at 514 (1946): "A personal representative who properly carries on the business of a decedent . . . for the purpose of profit over a definite or indefinite period, is a trustee; and this is true whether or not he be given this designation. It is irrelevant whether by his original appointment he was executor or testamentary trustee under a will, or an administrator appointed by the court. It is the substance of his duties, and not the name given him in the will, or by the court from which he derived his power, that is determinative."

[3] See, *e.g.,* Rosencrans v. Fry, 21 N.J. Super. 289, 91 A.2d 162 (Ch. 1952), *aff'd,* 12 N.J. 88, 95 A.2d 905 (1953); In the Matter of Estate of Doelger, 164 Misc. 590, 299 N.Y. Supp. 565 (Surr. Ct. 1937), *rev'd,* 254 App. Div. 178, 4 N.Y.S.2d 334, *aff'd per curiam,* 279 N.Y. 646, 18 N.E.2d 42 (1938); Green v. Philadelphia Inquirer Co., 329 Pa. 169, 196 Atl. 32 (1938).

[4] See notes 8-28 *infra* and accompanying text.

[5] See 2 SCOTT, TRUSTS § 193.2 (2d ed. 1956).

[6] Cahn, *Estate Corporations,* 86 U. PA. L. REV. 136, 138 (1937).

It is the purpose of this Note to determine whether Cahn's view continues to be correct as a proposition of law or desirable as a matter of policy. The area of conflict and the possible resolutions thereof will be analyzed. The validity of the dual fiduciary status, however, will be presumed; the propriety of both fiduciary duties co-existing in the same individual has been condoned. While the interests of the life tenant and the remainderman will be recognized, the major portion of the discussion will focus on the interests of corporate creditors and shareholders other than the trust; such interests have been given little consideration in previous writings concerning trust corporations.[7]

DUTY OF LOYALTY

Self-Dealing

Foremost of the duties owed by a trustee is that of loyalty—the obligation to act solely in the best interests of the beneficiaries.[8] This duty inhibits [9] or prohibits [10] action of the fiduciary in a conflict-of-interests situation.[11] While there are well-defined areas of conflict, situations on the peripheries of those areas require the sound discretion of a court of equity to determine at the outset whether the threat to the beneficial interests is of sufficient moment to require intervention.[12] When a conflict is found to exist, imposition of the duty is made on two levels.

Where the settlor has expressly [13] or by implication [14] authorized action in a conflict situation or where the beneficiaries have acquiesced

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[7] See, *e.g.*, Note, *supra* note 1.

[8] See generally 3 BOGERT, TRUSTS & TRUSTEES §§ 484-93, 543-44, 612 (1946); 2 SCOTT, TRUSTS §§ 170-.25 (2d ed. 1956); 4 *id.* §§ 497-506; Scott, *The Trustee's Duty of Loyalty*, 49 HARV. L. REV. 521 (1936).

[9] See notes 13-15 *infra* and accompanying text.

[10] See notes 17-19 *infra* and accompanying text.

[11] In addition to common-law requirements, the statutes of some states restrict self-dealing of fiduciaries. See, *e.g.*, CAL. CIV. CODE §§ 2229-30; N.Y. PERS. PROP. LAWS § 21(2); TEX. PROB. CODE § 352 (1956).

[12] See Ingalls v. Ingalls, 257 Ala. 521, 59 So. 2d 898 (1952); Estate of Guzzetta, 97 Cal. App. 2d 169, 217 P.2d 460 (Dist. Ct. App. 1950); Whiting v. Bryant, 102 Ohio App. 508, 131 N.E.2d 425 (1956); Manchester v. Cleveland Trust Co., 95 Ohio App. 201, 114 N.E.2d 242 (1953). *Compare* In the Matter of Hubbell, 302 N.Y. 246, 97 N.E.2d 888 (1951), *with* Estate of Keyston, 102 Cal. App. 2d 223, 227 P.2d 17 (Dist. Ct. App. 1951).

[13] In the Matter of Estate of Schuster, 35 Ariz. 457, 281 Pac. 38 (1929); Newton v. Old-Merchants Nat'l Bank & Trust Co., 299 Mich. 499, 300 N.W. 859 (1941); Finley v. Exchange Trust Co., 183 Okla. 167, 80 P.2d 296 (1938). In the particular context of the trustee-director, see Anderson v. Bean, 272 Mass. 432, 172 N.E. 647 (1930); Rosencrans v. Fry, 21 N.J. Super. 289, 91 A.2d 162 (Ch. 1952), *aff'd*, 12 N.J. 88, 95 A.2d 905 (1953); In the Matter of Estate of Doelger, 254 App. Div. 178, 4 N.Y.S.2d 334, *aff'd per curiam*, 279 N.Y. 646, 18 N.E.2d 42 (1938). *But see* UNIFORM TRUSTS ACT § 17.

[14] Martin v. Martin, 249 S.W.2d 542 (Ky. 1952); Robertson v. Hert's Adm'rs, 312 Ky. 405, 227 S.W.2d 899 (1950); see Steele Estate, 377 Pa. 250, 103 A.2d 409 (1954) (trustee-director); Flagg Estate, 365 Pa. 82, 73 A.2d 411 (1950) (trustee-director).

therein,[15] a transaction will be upheld only if the trustee can demonstrate that the dealing was in good faith and was fair and reasonable in all respects.[16] However, the merits of the transaction are not reached when neither the settlor nor the beneficiaries have consented.[17] In such a case, self-dealing is flatly prohibited.[18] The application of this "no further inquiry" rule makes voidable by the beneficiaries any transaction involving a conflict of interests if prior authorization has not been given.[19] Should the trustee act improperly in either circumstance, he will bear the risk of loss [20] to the trust and be held accountable for profits.[21]

The duty of loyalty of the corporate director is also clearly established [22] and has been said to be analogous to that of trustee to beneficiary.[23] The tests of fairness and no further inquiry are found also in the corporate

[15] Malone's Guardian v. Malone, 255 Ky. 210, 73 S.W.2d 38 (1934); Schockett v. Tublin, 170 Md. 117, 183 Atl. 521 (1936); Alburger v. Crane, 5 N.J. 573, 76 A.2d 812 (1950); Ungrich v. Ungrich, 141 App. Div. 485, 126 N.Y. Supp. 419 (1910), *aff'd mem.*, 207 N.Y. 662, 100 N.E. 1134 (1912); see 3 BOGERT, TRUSTS & TRUSTEES § 484 (1946); 2 SCOTT, TRUSTS § 170 (2d ed. 1956); *cf.* Ryan v. Plath, 20 Wash. 2d 663, 148 P.2d 946 (1944).

[16] See authorities cited notes 13-15 *supra.*

[17] See Schultz v. O'Hearn, 319 Ill. 244, 149 N.E. 808 (1925); Meade v. Vande Voorde, 139 Neb. 827, 299 N.W. 175 (1941); 3 BOGERT, TRUSTS & TRUSTEES § 484, at 99-100 (1946); Haggerty, *Conflicting Interests of Estate Fiduciaries in New York and the "No Further Inquiry" Rule*, 18 FORDHAM L. REV. 1 (1949); *cf.* Taussig v. Chicago Title & Trust Co., 171 F.2d 553 (7th Cir. 1948); Bowles v. Bowles, 141 Va. 35, 42, 126 S.E. 49, 51 (1925) (dictum).

[18] "In this conflict of interests, the law wisely interposes. It acts not on the possibility, that, in some cases, the sense of that duty may prevail over the motives of self-interest, but it provides against the probability in many cases, and the danger in all cases, that the dictates of self-interest will exercise a predominant influence, and supersede that of duty. It therefore prohibits a party from purchasing on his own account that which his duty or trust requires him to sell on account of another . . . ." Michoud v. Girod, 45 U.S. (4 How.) 502, 554-55 (1846). *Accord*, Schultz v. O'Hearn, 319 Ill. 244, 149 N.E. 808 (1925); *In re* Trusteeship Under Will of Riordan, 216 Iowa 1138, 248 N.W. 21 (1933); St. Paul Trust Co. v. Strong, 85 Minn. 1, 88 N.W. 256 (1901); Marcellus v. First Trust & Deposit Co., 291 N.Y. 372, 52 N.E.2d 907 (1943); see Haggerty, *supra* note 17.

[19] Schultz v. O'Hearn, 319 Ill. 244, 149 N.E. 808 (1925); Meade v. Vande Voorde, 139 Neb. 827, 299 N.W. 175 (1941); Alburger v. Crane, 5 N.J. 573, 577-78, 76 A.2d 812, 814 (1950) (dictum); Tiffany v. Clark, 58 N.Y. 632, 633 (1874) (dictum); *cf.* Taussig v. Chicago Title & Trust Co., 171 F.2d 553, 555 (7th Cir. 1948) (dictum); 3 BOGERT, TRUSTS & TRUSTEES § 484 (1946).

[20] In the Matter of Estate of Westhall, 125 N.J. Eq. 551, 5 A.2d 757 (Ct. Err. & App. 1939); In the Matter of Auditore, 249 N.Y. 335, 164 N.E. 242 (1928); Hayes v. Hall, 188 Mass. 510, 512, 74 N.E. 935, 937 (1905) (dictum); see 2 SCOTT, TRUSTS § 170.25 (2d ed. 1956).

[21] Magruder v. Drury, 235 U.S. 106 (1914); Vincent v. Werner, 140 Kan. 599, 38 P.2d 687 (1934); Clay v. Thomas, 178 Ky. 199, 198 S.W. 762 (1917); Calaveras Timber Co. v. Michigan Trust Co., 278 Mich. 445, 270 N.W. 743 (1936); see 2 SCOTT, TRUSTS § 170.25 (2d ed. 1956).

[22] See generally 3 FLETCHER, PRIVATE CORPORATIONS §§ 838-988 (perm. ed. rev. repl. 1947); 1 HORNSTEIN, CORPORATION LAW & PRACTICE §§ 431-51 (1959); 2 OLECK, MODERN CORPORATION LAW §§ 972-95 (1959). The statutes of several states have provisions indicating the conditions upon which self-dealing by directors will be permitted. See, *e.g.*, CAL. CORP. CODE § 820; MICH. COMP. LAWS § 450.13(5) (1948); R.I. GEN. LAWS ANN. § 7-4-7 (1956).

[23] See 3 FLETCHER, *op. cit. supra* note 22, § 838; 2 OLECK, *op. cit. supra* note 22, § 972; Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931).

area;[24] however, the choice of the applicable rule is here influenced by the collegiate nature of the directorate. It may be that the interested director has in no way participated in the board decision which works to his own advantage. If he joins in the directorial action, it may be that his participation was necessary to constitute a quorum or to gain approval of the transaction; on the other hand, it is possible that his presence, or vote, or both, were superfluous.[25] A minority of courts apply a test of fairness in each of the above instances, thus preventing the existence of self-dealing per se from destroying a transaction otherwise beneficial to the corporation.[26] Others have imposed the strict rule, which makes voidable by the corporation any self-dealing transaction.[27] The majority of jurisdictions will apply the per se rule in cases where the interested director's participation was necessary to the result; the fairness criterion is used when he did not take part or when his contribution was unneeded.[28]

The rules in the two areas have much in common. In both, the essence of the duty of loyalty is fairness. In both, the question of fairness usually will not be reached unless special circumstances exist which place the conflict of interest beyond the absolute prohibition rule—in the case of a trustee, express or implied authorization from the settlor or the beneficiaries; in the case of a director, something similar to authorization through the approval of a more-than-sufficient number of disinterested directors.

The Broader Implications of the Duty

Self-dealing of either director or trustee is but one, albeit the primary, aspect of the application of the duty. But as a basic obligation of the fiduciary to act solely in the interests of those beneficially involved, the duty may be violated also by advancing the interests of a third party in preference to those to whom the duty is owed.[29] Thus, as to the trustee

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[24] See authorities cited notes 26-28 *infra.*

[25] See 2 OLECK, *op. cit. supra* note 22, § 972.

[26] See, *e.g.*, Ransome Concrete Mach. Co. v. Moody, 282 Fed. 29 (2d Cir. 1922); Wyman v. Bowman, 127 Fed. 257 (8th Cir. 1904); Minnesota Loan & Trust Co. v. Peteler Car Co., 132 Minn. 277, 156 N.W. 255 (1916); Savage v. Madelia Farmers' Warehouse Co., 98 Minn. 343, 108 N.W. 296 (1906); Jordan v. Jordan Co., 94 Conn. 384, 393, 109 Atl. 181, 184 (1920) (dictum); Nicholson v. Kingery, 37 Wyo. 299, 302, 261 Pac. 122, 124 (1927) (dictum); *cf.* Note, 61 HARV. L. REV. 335 (1948).

[27] See, *e.g.*, Morgan v. King, 27 Colo. 539, 63 Pac. 416 (1900); Pearson v. Concord R.R., 62 N.H. 537, 13 Am. St. Rep. 590 (1883); Munson v. Syracuse, G. & C.R.R., 103 N.Y. 59, 8 N.E. 355 (1886); *cf.* Clapp v. Wallace, 221 Iowa 672, 266 N.W. 493 (1936); Cuthbert v. McNeill, 103 N.J. Eq. 199, 200, 142 Atl. 819, 820 (Ch. 1928) (dictum). The force of the *Munson* case seems to have been reduced in New York by the language of Everett v. Phillips, 288 N.Y. 227, 43 N.E.2d 18 (1942); see Piccard v. Sperry Corp., 48 F. Supp. 465, 467 (S.D.N.Y. 1943), *aff'd per curiam*, 152 F.2d 462 (2d Cir.), *cert. denied*, 328 U.S. 845 (1946).

[28] See, *e.g.*, Cook v. Malvern Brick & Tile Co., 194 Ark. 759, 109 S.W.2d 451 (1937); Louisville, N.A. & C. Ry. v. Carson, 151 Ill. 444, 38 N.E. 140 (1894); Chilton v. Bell County Coke & Improvement Co., 153 Ky. 775, 156 S.W. 889 (1913); Nye v. Storer, 168 Mass. 53, 46 N.E. 402 (1897). *Compare* Ft. Payne Rolling Mill v. Hill, 174 Mass. 224, 54 N.E. 532 (1899), *with* Nye v. Storer, *supra.*

[29] *Cf.* 3 BOGERT, TRUSTS & TRUSTEES § 543, at 375-76 (1946).

or director the duty of loyalty in the narrow sense would appear an important but limited restriction on activity in favor of self; in the broader sense, where the two institutions are joined by a common fiduciary, any exercise of discretion in one capacity may be considered as not in the best interests of the other institution and therefore a breach of the duty. This broader problem goes to the heart of the determination of the rules to be applied to transactions between the corporation and the trust, and to the exercise of discretion in each capacity.

Transactions

The situation in which the trustee-director finds himself is one where control over the activities of two institutions, exercised in a fiduciary capacity, rests in the same hands. The same may be said of two corporations controlled by interlocking directorates. For this reason the treatment by the courts of transactions between such corporations would seem to provide a particularly useful analogy in the present problem.[30]

Older cases held that any transaction between corporations having common directors was voidable at will by either corporation.[31] Although some courts may still apply this rule—particularly when the same persons constitute a majority of both boards[32]—most jurisdictions now hold that the corporation wishing the benefit of the contract may prevent avoidance by sustaining the burden of proving that the transaction was fair and reasonable.[33] In some cases the courts have gone so far as to place the burden of showing unfairness upon the proponent of avoidance.[34] Regardless of the rule to be applied, the ratification of the transaction by the shareholders is usually held to cure the defect.[35]

A similar treatment of the trust-corporation transaction would permit either institution to avoid an agreement in which a fiduciary has dealt on both sides, if the other cannot sustain the proof of fairness. In this way the beneficial interests of each will be protected: neither is subordinated to the other, and both may obtain the benefit of a fair contract. A departure from the rule would, in the intracorporate aspect, prefer one group of shareholders over another. More stringent protection for the trust would injure the remaining shareholders, while any preference to the corporation would benefit independent interests at the expense of the trust. Such a departure

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30 As to treatment of interlocking-directorate transactions, see generally 1 HORNSTEIN, *op. cit. supra* note 22, § 439; 2 OLECK, *op. cit. supra* note 22, § 972; Bayne, *The Fiduciary Duty of Management—The Concept in the Courts*, 35 U. DET. L.J. 561 (1958); Note, 51 HARV. L. REV. 327 (1937); Note, 81 U. PA. L. REV. 598 (1933).

31 See Bayne, *supra* note 30, at 575-76; Note, 61 HARV. L. REV. 335 (1948).

32 See 2 OLECK, *op. cit. supra* note 22, § 972; 1 HORNSTEIN, *op. cit. supra* note 22, § 439.

33 See Bayne, *supra* note 30, at 576; Note, 61 HARV. L. REV. 335 (1948); *cf.* 2 OLECK, *op. cit. supra* note 22, § 972.

34 See 2 OLECK, *op. cit. supra* note 22, § 972; Bayne, *supra* note 30, at 576.

35 See HORNSTEIN, *op. cit. supra* note 22, § 439, at 543; Note, 51 HARV. L. REV. 327, 329-30 (1937).

erodes, without apparent justification, the fiduciary duty owing to each institution.

Discretion

In determining the relative weight to be given the competing interests of trust and corporation in the exercise of fiduciary discretion, it is necessary to consider how the courts have treated the relationship between the two institutions in light of testamentary intent. Two possible views of this relationship were expounded in the surrogate and appellate division decisions in *In the Matter of Estate of Doelger*.[36] In that case, the testator ordered the incorporation of his business,[37] and pursuant to his direction certain restrictions on corporate actions were written into the bylaws.[38] The executors elected themselves directors;[39] thereafter, the corporate shares were to be placed in several trusts, with the executors as trustees.[40] At the time of the suit, only fifty per cent of the shares were still held by the trustees,[41] the balance having passed out of trust to remaindermen. A portion of these shares had come into the hands of strangers to the trust arrangement.[42] The trustee-directors had invested corporate funds in securities which the trustees, as such, would not have been permitted to hold.[43] The restrictions in the corporate bylaws did not deal with the investment powers in issue. It was the theory of the surrogate that the fact of incorporation under direction of the will subjected the corporation's operations to the limitations of trust law when there was no express authorization to the contrary.[44] Thus, while the testator might have granted full corporate investment powers, his failure to do so left the fiduciary inhibited by the restrictive trust rules in the investment of corporate funds,[45] even "when strangers to the trust come in as stockholders . . . ."[46] The surrogate court's view of the applicability of trust law seems to be shared by other courts—especially when the trust is the sole shareholder.[47]

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[36] 164 Misc. 590, 299 N.Y. Supp. 565 (Surr. Ct. 1937), *rev'd*, 254 App. Div. 178, 4 N.Y.S.2d 334, *aff'd mem.*, 279 N.Y. 646, 18 N.E.2d 42 (1938).

[37] 254 App. Div. at 180-81, 4 N.Y.S.2d at 336-37.

[38] *Id.* at 180-81, 4 N.Y.S.2d at 337.

[39] *Ibid.*

[40] *Id.* at 180, 4 N.Y.S.2d at 337.

[41] *Id.* at 182, 4 N.Y.S.2d at 338.

[42] 164 Misc. at 598, 299 N.Y. Supp. at 574.

[43] 254 App. Div. at 182, 4 N.Y.S.2d at 338.

[44] 164 Misc. at 599, 299 N.Y. Supp. at 575.

[45] *Id.* at 601-02, 299 N.Y. Supp. at 578. Most states have statutes controlling trust investment. See, *e.g.*, IOWA CODE ANN. § 682.23 (1950), as amended, § 682.23(15) (Supp. 1960); KY. REV. STAT. § 386.020(1) (1956); WIS. STAT. ANN. § 320.01 (Supp. 1960). See generally 3 SCOTT, TRUSTS §§ 227-231.4 (2d ed. 1956).

[46] 164 Misc. at 601, 299 N.Y. Supp. at 577.

[47] See *In re* Trust Under Will of Koffend, 218 Minn. 206, 15 N.W.2d 590 (1944); In the Matter of Hubbell, 302 N.Y. 246, 97 N.E.2d 888 (1951); In the Matter of Shehan, 285 App. Div. 785, 141 N.Y.S.2d 439 (1955); Weston v. Weston, 210 S.C. 1, 41 S.E.2d 372 (1947); *In re* Teasdale's Estate, 261 Wis. 248, 52 N.W.2d 366 (1952). *But see* Anderson v. Bean, 272 Mass. 432, 172 N.E. 647 (1930); Boyle v. John Boyle

The appellate division took a directly opposed view.[48] It held that, while express restrictions on the power of the corporation might be required by will,[49] in the absence of such a direction the limitations applicable to a trust corporation are those implied by corporate law, not trust law:

> A clear distinction must be made between the powers and limitations of a corporation formed pursuant to directions in the will and the powers and limitations of a trustee appointed under the will. The testator designates his trustee and has power to give the trustee absolute and unlimited discretion in investments. As the testator has such power, if he does not use it and says nothing about the trustee's right to invest, the law limits the trustee to what are designated as legal investments. But the testator cannot either create, or confer powers on, a corporation. The sovereign alone has such power. And when on the executor's petition it creates a corporation, the state and not the testator gives the corporation all the powers it possesses, including the powers of investment that are usual, legal, and customary in such corporation. As the testator can give no power to the corporation, his silence does not keep from it any the law confers. In the case of the trustee, since the testator has the power to give discretionary authority in investments, silence means limitation. In the case of the corporation, since the testator has no such power, silence means the absence of limitation.[50]

The reasoning of the court may be slightly unrealistic in that the testator's power over the trustee is dependent upon state law no less than is the power over a corporation. But as an expression of the essential difference in socio-economic function which the two institutions perform, the analysis of the appellate division is sound. The trust has been traditionally considered a useful device for preservation and conservation of property for the benefit of objects of the settlor's bounty.[51] It is no less clear that the corporate form is appropriate for the risk employment of capital in commercial situations. For a court to hold as did the surrogate is to preclude utilization of a device which is suitable for settlors who desire that their funds be put to more dynamic use than that offered by the stolidity inherent in the traditional trust. The appellate division recognized this need and by the use of the convenient touchstone of "testator's intent" [52] incorporated such

& Co., 136 App. Div. 367, 120 N.Y. Supp. 1048 (1910), *aff'd mem.*, 200 N.Y. 597, 94 N.E. 1092 (1911); *In re* Edwards' Will, 102 N.Y.S.2d 715 (Surr. Ct. 1950), *aff'd mem.*, 279 App. Div. 841, 109 N.Y.S.2d 844 (1952); Goetz's Estate (No. 1), 236 Pa. 630, 85 Atl. 65 (1912).

[48] 254 App. Div. 178, 4 N.Y.S.2d 334, *aff'd mem.*, 279 N.Y. 646, 18 N.E.2d 42 (1938).

[49] *Id.* at 184, 4 N.Y.S.2d at 340.

[50] *Id.* at 183-84, 4 N.Y.S.2d at 339-40.

[51] *Cf.* 3 BOGERT, TRUSTS & TRUSTEES § 582 (1946); RESTATEMENT (SECOND), TRUSTS § 176 (1959); 2 SCOTT, TRUSTS § 176 (2d ed. 1956).

[52] See In the Matter of Estate of Doelger, 254 App. Div. 178, 183, 4 N.Y.S.2d 334, 339, *aff'd per curiam*, 279 N.Y. 646, 18 N.E.2d 42 (1938).

a device into the law of New York. But one wonders about the use of this phrase as the sole basis for decision. As long as the corporate bylaws explicitly express the testator's intention to restrict the action of the directors, there can be no objection to the restrictions so imposed, and the limited ground of decision is satisfactory.[53] However, restrictions on action which do not appear in the bylaws work silently against the interests of creditors and other stockholders, and it would be appropriate for a court to inquire into their effect upon these interests as well.

The New Jersey Superior Court did so in *Rosencrans v. Fry*,[54] which presented, *inter alia*, the question of the power of the trustee to withhold dividends when he is acting as director of the corporation.[55] The dogma of "testator's intent" was used in reaching the result,[56] but the court went significantly further and considered independent interests.[57] The duty of the trustee to vote shares in such a way as to promote the interests of the beneficiaries was recognized,[58] but the court stated that this obligation

> does not embrace a duty to advance the interests of a beneficiary at the expense of the corporation and other outstanding stockholders' interests. That duty must be adjusted with the duty of a director as such. And where, as here, better than 50% of the shares are held by others, and the policy of the board [of directors] is unassailable from the standpoint of the company's interests . . . [the trustee] cannot be said to have been remiss in his duty as co-trustee.[59]

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[53] Professor Cahn has suggested a chronological distinction in remedies available to independent shareholders. Thus, the power to force corporate dissolution or require the retirement of his stock might be available if the interest were held prior to the testator's placing the corporation in trust. A subsequent investor, however, is provided no means of escape from the "corporation," although it is suggested that his vendor had a duty to disclose the nature of the situation and presumably may be held liable for his failure to do so. Cahn, *supra* note 6, at 145. By this scheme the subsequent investor is given no choice at all; and the alternatives available to the prior investor are not meaningful. Submission to the trust is to participate in a corporation in name only, see text accompanying and following notes 76-79 *infra*. Dissolution destroys the testamentary scheme as well as the investment of the third party, and forced repurchase by the corporation may well contravene corporate law by requiring a distribution of capital permanently dedicated to the business when no retained earnings are available for the purpose. See, *e.g.*, IND. ANN. STAT. § 25-251(1) (1960) (director liable for knowingly assenting to distributions to shareholders which impair capital); *cf.* text accompanying notes 80-81 *infra*. The only choice in which such an investor would be interested—to retain his position in a vital organization—is omitted.

[54] 21 N.J. Super. 289, 91 A.2d 162 (Ch. 1952), *aff'd*, 12 N.J. 88, 95 A.2d 905 (1953).

[55] The need for examination into the propriety of performance of the trustee as a director from the corporate viewpoint was recognized; the court was clearly aware that his dual position might lead to divergent obligations. 21 N.J. Super. at 296, 297, 91 A.2d at 165, 166. The court expressly confined its discussion on this point to the duties of the trustee in regard to the corporation and admitted that it could not, in the case before it, adjudicate the rights of shareholders against the corporation. *Ibid.*

[56] See *id.* at 297, 91 A.2d at 166.

[57] *Id.* at 301, 91 A.2d at 168.

[58] *Id.* at 300-01, 91 A.2d at 167-68.

[59] *Id.* at 301, 91 A.2d at 168.

The adjustment in New Jersey, when the trustee acts within the scope of his greater discretion as director, would seem to favor the corporate rather than the trust law—a preference deriving from an awareness and recognition of the competing policy interests, as well as an inquiry into the "testator's intent."

THE UNDERLYING CONFLICT

At the core of the problem of resolving the fiduciary conflict is the functional contrast between the two institutions involved. The corporation is the most important economic institution in modern capitalistic society.[60] It is the major conduit through which the flow of risk capital is directed to appropriate areas of the economy. To perform its functions of control of capital and labor so as to participate effectively in the proper allocation of these resources, a wide range of discretion must be vested in the directorate.[61] The necessary discretion is obviously frustrated when the choice of various alternatives is circumscribed by rules unassociated with commercial reality.

The trust is also a device for control of capital. But this institution has developed much as the antithesis of risk capital employment; it is designed to conserve and protect assets. The legal duties which have evolved in this area further this conservative purpose and, to some extent, cannot be varied even by the settlor.[62] Some discretion is permitted if not required,[63] but its scope is severely narrowed by operation of law.[64] For instance, in terms of fiduciary freedom in the utilization of funds, the trust is distinctly and deliberately far less flexible than the corporation.[65]

When these two contrasting structures are merged in a trust corporation, the courts are faced with the choice of applying trust law [66] or corporate law [67] or some newly developed body of law to the activities of the director-trustee. It must be considered who is served by the use of each rule.

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[60] See MASON, THE CORPORATION IN MODERN SOCIETY 1 (1960).

[61] *Ibid.* *Cf.* Note, 61 HARV. L. REV. 335, 336-37 (1948): "Not only did the obvious legal differences in the position of a trustee and a director make it inapt [to identify the director's role as that of a trustee], but the director's practical need for a greater freedom of initiative made the trustee's straight-jacket a troublesome restraint."

[62] See 2 SCOTT, TRUSTS §§ 185A, 186 (2d ed. 1956).

[63] *Id.* § 187.

[64] *Ibid.*

[65] *Cf.* 1 BOGERT, TRUSTS & TRUSTEES § 17, at 101-02 (1946), where the author indicates the relative flexibility of trust and contract. *But cf.* Scott, *Deviation From the Terms of a Trust*, 44 HARV. L. REV. 1025, 1026 (1931): "The trust is one of the most flexible juridical devices in our legal system." Scott is there speaking of the device as one which the settlor may, within limits, employ "for such purposes and subject to such provisions as the settlor may choose." *Ibid.* The text is addressed to a different level of trust employment: the exercise of discretion by the trustee. Scott's remarks do not go to flexibility in that aspect. To the same effect as Scott is Isaacs, *Trusteeship in Modern Business*, 42 HARV. L. REV. 1048, 1052-54 (1929).

[66] See notes 44-47 *supra* and accompanying text.

[67] See notes 48-50 *supra* and accompanying text.

Application of Trust Law

The application of trust rules is premised on the theory that the corporation is to be operated in the best interests of the trust.[68] This interest is closely identified with that of the life tenant as opposed to the remainderman, since the former is considered the primary object of the settlor's bounty.[69] Thus, power of investment may be curtailed,[70] use of depreciation may be disallowed,[71] retention of earnings for expansion may be denied,[72] and various other restrictions upon directorial discretion may be imposed.[73] In the simple trust situation, free of corporate complexities, the testator's intentions are of utmost importance.[74] But where the corpus includes shares enabling the trustee to exercise corporate control, the inhibition of directorial discretion will not merely prefer life tenant over remainderman, but will subordinate as well the interests of independent shareholders and creditors of the corporation.

If the trustee-director *exceeds* the powers conferred upon him as director, the independent parties adversely affected will most probably have a remedy.[75] A more subtle infringement of independent rights occurs when trust restrictions *narrow* the otherwise allowable range of corporate action.[76] Instead of transgressing his corporate authority, the director is effectively precluded from exercising the full scope of that authority inasmuch as trust restrictions carry with them trust remedies for their breach. Under corporate law, the maximum sanction facing a director for unpopular action within the scope of permissible discretion is removal.[77]

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[68] See *In re* Trust Under Will of Koffend, 218 Minn. 206, 15 N.W.2d 590 (1944); Erickson v. Starling, 233 N.C. 539, 542, 64 S.E.2d 832, 834-35 (1951) (dictum); Weston v. Weston, 210 S.C. 1, 17, 41 S.E.2d 372, 379 (1947) (dictum).

[69] *Cf.* McCracken v. Gulick, 92 N.J. Eq. 214, 112 Atl. 317 (Ct. Err. & App. 1920); *In re* Knox's Estate, 328 Pa. 177, 195 Atl. 28 (1937); Chapin v. Collard, 29 Wash. 2d 788, 189 P.2d 642 (1948).

[70] See, *e.g.*, In the Matter of Estate of Doelger, 164 Misc. 590, 299 N.Y. Supp. 565 (Surr. Ct. 1937), *rev'd*, 254 App. Div. 178, 4 N.Y.S.2d 334 (1938), *aff'd per curiam*, 279 N.Y. 646, 18 N.E.2d 42 (1938); *cf. In re* Wacht's Estate, 32 N.Y.S.2d 871 (Surr. Ct. 1942).

[71] See, *e.g.*, In the Matter of Estate of Adler, 164 Misc. 544, 299 N.Y. Supp. 542 (Surr. Ct. 1937).

[72] See, *e.g.*, *In re* Trust Under Will of Koffend, 218 Minn. 206, 15 N.W.2d 590 (1944); *cf.* In the Matter of Shehan, 285 App. Div. 785, 141 N.Y.S.2d 439 (1955).

[73] See, *e.g.*, In the Matter of Horowitz, 297 N.Y. 252, 78 N.E.2d 598 (1948); In the Matter of Estate of McLaughlin, 164 Misc. 539, 299 N.Y. Supp. 559 (Surr. Ct. 1937).

[74] See Upman v. Plankinton, 152 Wis. 275, 284, 140 N.W. 5, 8 (1913); 1 SCOTT, TRUSTS § 4 (2d ed. 1956); 2 *id.* §§ 164, 164.1; RESTATEMENT (SECOND), TRUSTS §§ 4, 164 (1959); Isaacs, *supra* note 65, at 1052; *cf.* 2 SCOTT, TRUSTS §§ 167.1-.2 (2d ed. 1956); RESTATEMENT (SECOND), TRUSTS § 167 (1959).

[75] See 3 OLECK, MODERN CORPORATION LAW § 1594, at 666 (1959). See generally 2 *id.* §§ 840-43; 3 *id.* §§ 1589-602.

[76] See Cahn, *Estate Corporations*, 86 U. PA. L. REV. 136, 145 (1937). See also 2 OLECK, *op. cit. supra* note 75, § 960.

[77] Some statutes permit removal of a director without cause by the vote of a specified majority of shareholders at any time during the director's term. See, *e.g.*, CAL. CORP. CODE § 810; LA. REV. STAT. § 12:34(c)(4) (1950); MICH. COMP. LAWS § 450.13.3 (1948). Generally, however, removal without cause must await the end

However, the application of trust rules may transform this permissible corporate action into a breach of trust duty and subject the fiduciary to monetary liability in addition to removal.[78] It is doubtful that the trustee-director will feel free to follow his corporate conscience when faced with the possibility of surcharge—especially where this possibility hinges upon the clarification of confusing and seemingly contradictory rules of law.[79] In addition, the independent interests in the corporation, reasonably expecting the management to have the full range of power accorded under the law of corporations, may find themselves relegated to the status of trust beneficiaries—a position they had no intention of assuming. These restraints cannot but injure the corporation competitively. What the courts have characterized as conservation of trust corpus works in the corporate context to destroy the vitality of management necessary in the commercial world. To place the corporation on an economic treadmill is to invite if not to insure economic disaster for the enterprise; this can work to the advantage of no one concerned.

In addition to its effect on the nature of the investment, the application of trust rules in the corporate sphere also has an impact upon the integrity of the investment and the protection which this invested capital affords creditors. Corporate law is explicit in providing rules of "stated" or "legal" capital, by which distribution of the corporate assets to the shareholders—such as dividends—may not be made beyond the point at which assets equal liabilities plus stated capital;[80] these rules have sometimes been referred to, for better or for worse, as the "trust fund doctrine."[81]

In the usual case, this excess over liabilities and stated capital represents current income or earnings retained from previous periods,[82] and

of the director's term in office. See 2 FLETCHER, PRIVATE CORPORATIONS § 352 (rev. vol. 1954). Under common law a majority of the stockholders may, without statutory provision, remove a director for misconduct in office. See 2 OLECK, *op. cit. supra* note 75, § 990.

[78] See 2 SCOTT, TRUSTS § 187.1 (2d ed. 1956).

[79] In New York, for example, *compare* Boyle v. John Boyle & Co., 136 App. Div. 367, 120 N.Y. Supp. 1048 (1910), *aff'd per curiam*, 200 N.Y. 597, 94 N.E. 1092 (1911), *and* In the Matter of Estate of Doelger, 254 App. Div. 178, 4 N.Y.S.2d 334, *aff'd per curiam*, 279 N.Y. 646, 18 N.E.2d 42 (1938), *and In re* Edwards' Will, 102 N.Y.S.2d 715 (Surr. Ct. 1950), *aff'd per curiam*, 279 App. Div. 841, 109 N.Y.S.2d 844 (1952), *with* In the Matter of Estate of McLaughlin, 164 Misc. 539, 299 N.Y. Supp. 559 (Surr. Ct. 1937), *and* In the Matter of Estate of Adler, 164 Misc. 544, 299 N.Y. Supp. 542 (Surr. Ct. 1937), *and* In the Matter of Hubbell, 302 N.Y. 246, 254, 97 N.E.2d 888, 891 (1951) (dictum). Compare In the Matter of Estate of Angell, 268 App. Div. 338, 52 N.Y.S.2d 52 (1944), *aff'd per curiam*, 294 N.Y. 923, 63 N.E.2d 117 (1945); In the Matter of Will of Maas, 257 App. Div. 134, 12 N.Y.S.2d 159, *aff'd per curiam*, 281 N.Y. 866, 24 N.E.2d 502 (1939).

[80] What is considered to be stated capital is determined by the statute of the particular state. See, *e.g.*, FLA. STAT. ANN. § 608.17 (1956); OHIO REV. CODE ANN. § 1701.30 (Page Supp. 1960); TEX. BUS. CORP. ACT. art. 2.17 (Supp. 1956). See Ballantine & Hills, *Corporate Capital and Restrictions Upon Dividends Under Modern Corporation Laws*, 23 CALIF. L. REV. 229, 232-33 (1935); 1 HORNSTEIN, CORPORATION LAW AND PRACTICE § 463 (1959); 2 OLECK, *op. cit. supra* note 75, §§ 610, 624-25. See generally *id.* §§ 606-25.

[81] See Ballantine & Hills, *supra* note 80, at 230. For an early case in which the "trust fund doctrine" was applied, see Wood v. Dummer, 30 Fed. Cas. 435 (No. 17944) (C.C.D. Me. 1824).

[82] See KARRENBROCK & SIMONS, INTERMEDIATE ACCOUNTING 693-94 (3d ed. 1958).

will be distributable as dividends.[83] But if income has in any period been overstated, that amount paid out in excess of the total income correctly computed will constitute a reduction of assets below the level of liabilities plus stated capital and violate the distribution rule.[84]

For example, depreciation[85] is an expense properly charged against revenues to determine income;[86] a failure to depreciate appropriate assets will overstate income and have the indicated result.[87] A continuing refusal to take depreciation is a continuing impairment of capital.[88] A continuing violation of the rules prohibiting such distributions would ultimately result

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[83] FINNEY & MILLER, PRINCIPLES OF ACCOUNTING—INTERMEDIATE 136-37 (5th ed. 1958). See KARRENBROCK & SIMONS, *op. cit. supra* note 82, at 696-97. For statutory provisions to this effect, see, *e.g.*, FLA. STAT. ANN. § 608.52 (1956) (dividends from earnings or surplus of assets over liabilities including capital); OHIO REV. CODE ANN. §§ 1701.32-.33 (Page Supp. 1960) (dividends out of surplus defined as excess of assets over liabilities plus stated capital). Directors are held liable for improper distributions. See, *e.g.*, IND. ANN. STAT. § 25-251(1) (1960) (knowingly assenting to distributions to shareholders which impair capital).

[84] See FINNEY & MILLER, *op. cit. supra* note 83, at 135, 356; KARRENBROCK & SIMONS, *op. cit. supra* note 82, at 696-97.

[85] For purposes of this discussion, since the expensing or lack thereof is the only concern, the form of depreciation taken is of no consequence and is not considered. As contemplated herein, charging the expense against revenues of a single period is of equal merit, for example, to using a straight-line method—although the former would not normally be considered within the connotations of the term depreciation. As to the difficulties of defining depreciation, see SALIERS, DEPRECIATION PRINCIPLES AND APPLICATIONS 38-41 (3d ed. 1939). See generally FINNEY & MILLER, *op. cit. supra* note 83, at 352-77.

[86] Wittenberg v. Federal Mining & Smelting Co., 15 Del. Ch. 147, 133 Atl. 48 (Ch. 1926), *aff'd*, 15 Del. Ch. 409, 138 Atl. 347 (Sup. Ct. 1927); Whittaker v. Amwell Nat'l Bank, 52 N.J. Eq. 400, 29 Atl. 203 (Ch. 1894); see Fitts, *The Relation of Depreciation to the Determination of Surplus and Earnings Available for Dividends*, 33 VA. L. REV. 581 (1947); *cf.* Propp, *Depreciation of Buildings Held in Testamentary Trusts*, 19 N.Y. CERTIFIED PUBLIC ACCOUNTANT 170 (1949).

[87] FINNEY & MILLER, *op. cit. supra* note 83, at 356: "There is now . . . a sufficient body of court decisions to establish the fact that the law requires a provision for depreciation, and that the payment of dividends to the full amount of the surplus, without a provision for depreciation, would constitute an impairment of capital." See People *ex rel.* Binghamton Light, Heat & Power Co. v. Stevens, 203 N.Y. 7, 22-24, 96 N.E. 114, 118-19 (1911); Knoxville v. Knoxville Water Co., 212 U.S. 1, 13-14 (1909) (dictum); People *ex rel.* Jamaica Water Supply Co. v. State Bd. of Tax Comm'rs, 128 App. Div. 13, 17-18, 112 N.Y. Supp. 392, 395 (1908) (dictum), *modified on other grounds*, 196 N.Y. 39, 89 N.E. 581 (1909); ASHER, SURVEY OF ACCOUNTING 483-84 (1952); KARRENBROCK & SIMONS, *op. cit. supra* note 82, at 799-800; *cf.* Myer, *Depreciation and Recovery of Cost*, 19 N.Y. CERTIFIED PUBLIC ACCOUNTANT 303 (1949); Peloubet, *Are We Giving Away Our Capital Without Knowing It?*, 18 N.Y. CERTIFIED PUBLIC ACCOUNTANT 440 (1948).

[88] It may be noted that while depreciation at cost may prevent impairment in the accounting sense and thus technically satisfy the rule of stated capital, it will not prevent an economic impairment of capital in an inflationary economy. "If we are charging into our costs depreciation on a plant built ten or fifteen years ago on the basis of its cost at that time, we are understating our costs and overstating our income on a current basis to the extent of the difference in the depreciation on the present value of the machinery and equipment and depreciation on its cost at the time of acquisition." Peloubet, *supra* note 87, at 443. Unfettered corporations may provide for this aspect of economic erosion by the capitalization of retained earnings. But retention of earnings is another area in trust corporation law which is not clear; some courts may not permit retention of earnings, at least for this purpose. See generally Peloubet, *supra* note 87; Myer, *supra* note 87.

in the complete impairment of capital and an ensuing insolvency in the bankruptcy sense.[89]

But a large body of trust law indicates that depreciation cannot be taken.[90] Such a practice is considered to be an impermissible conversion of income into corpus.[91] The application of this principle accords with the usual preference given the life tenant; courts so holding show little concern for the reduction in value of the remainder. Even if it is assumed that the no-depreciation rule is proper for the noncommercial enterprise, when the rule is applied to corporate operations there is a direct conflict with the rule for the preservation of capital. This rule of legal or stated capital serves to protect the interests of all shareholders and creditors.[92] Since the creditors have priority over the claims of the shareholders, the stated capital represents assets providing protection in addition to the precise amount necessary to satisfy obligations to creditors. This buffer is destroyed when the stated capital is impaired by distribution of these assets to the shareholders as dividends. This impairment by definition reduces the shareholders' ability to realize their claims against assets shown on the corporate books. If there are senior classes of shares, their preferred position may be impaired. In any event, all shareholders, by accepting the delusive dividends, will be participating in the partial liquidation of their investment.[93] Obviously, the use of trust rules emasculates established corporate doctrine. Not only are independent ownership and creditor interests injured, but the income-producing capacity of the corporation from the viewpoint of the trust is also reduced. In the commercial area of the corporation, even the life tenant seems ill-served by the application of trust principles such as the no-depreciation rule.

This last point raises a further question regarding the application of trust law—the validity of the initial presumption as to the testator's intent.

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[89] See cases cited note 87 *supra*.

[90] Cases in some jurisdictions hold that no depreciation may be taken unless a contrary intention of the testator appears. See, *e.g.*, Evans v. Ockershausen, 100 F.2d 695, 708-09 (D.C. Cir. 1938); *In re* Roth, 139 N.J. Eq. 588, 52 A.2d 811 (Prerogative Ct. 1947); Chapin v. Collard, 29 Wash. 2d 788, 189 P.2d 642 (1948). Commentators, considering the distinction between depletion and depreciation to be one of degree only, have grouped depreciable with wasting assets and have stated a different rule: "Unless it is otherwise provided by the terms of the trust, if property held in trust to pay the income to a beneficiary for a designated period and thereafter to pay the principal to another beneficiary is wasting property, the trustee is under a duty to the beneficiary who is entitled to the principal, either (a) to make provision for amortization, or (b) to sell such property. RESTATEMENT (SECOND), TRUSTS § 239 (1959); *accord*, 3 SCOTT, TRUSTS § 239 (2d ed. 1956). The rule's exception—based on testator's intent—has resulted in a great number of cases denying the right to deplete or depreciate. See, *e.g.*, Dexter v. Dexter, 274 Mass. 273, 174 N.E. 493 (1931); *In re* Knox's Estate, 328 Pa. 177, 195 Atl. 28 (1937); Leach v. McCreary, 183 Tenn. 128, 191 S.W.2d 176 (1945). See generally Capron, *Reserves Against the Depreciation of Real Property Held by a Trustee*, 12 OHIO ST. L.J. 565 (1951); Propp, *supra* note 86, at 170.

[91] See In the Matter of Estate of Adler, 164 Misc. 544, 549-57, 299 N.Y. Supp. 542, 554-59 (Surr. Ct. 1937).

[92] Ballantine & Mills, *supra* note 80, at 233.

[93] FINNEY & MILLER, *op. cit. supra* note 83, at 135.

The presumption goes beyond a supposed superior interest in the welfare of the life tenant and affects the essence of the testamentary scheme when a trust corporation is involved. A vigorous operation of the trust presumption takes from the testator a convenient device for the operation of a business by the estate in a fully risk-taking manner. There is no necessary inconsistency in a testator's having a primary interest in the welfare of his life tenant and also being of the opinion that an uninhibited corporation is the best way to serve that interest. By inhibition the court denies the testator the right to make that determination and denies the availability of a tool whereby a business in trust can grow and remain an active enterprise. The testator can obtain that desired freedom only by express description of corporate powers and even then probably could not succeed completely.[94]

The application of trust rules, then, substitutes the court's judgment for that of the directors to the detriment of independent interests, and constructs a new scheme in place of that expressly chosen by the testator—thereby precluding the use of a valuable testamentary instrument designed to avoid the unimaginative rigors of trust administration.

Application of Corporate Law

When corporate rules are applied to the corporation in trust, different results obtain. The problems of the preceding section are resolved so as to protect the interests of the shareholders and creditors. In addition, the remainderman is given a more advantageous position in relation to the life tenant, inasmuch as the value of the shares of stock held in trust may increase and be turned over at a higher value at the termination of the trust. This increment in value may be due to the improved prospects of the enterprise or may be a direct result of earnings retained by the corporation for contingencies or expansion. This is not to say that the presumption in favor of the life tenant is to be eliminated. It merely raises an equally forceful presumption in favor of protecting the independent interests, which may incidentally prefer the remainderman. Such conflict as exists between these presumptions should be resolved in a manner that provides maximum protection and minimum injury. It has been shown that trust law introduces absolutes which cannot but work to the detriment of all outside interests. Corporate law protects these interests and at the same time permits the trustee to fulfill his duties within the trust sphere. For instance, where a trust holds a noncontrolling minority interest in a corporation, the trustee may be under a duty to sell nonproductive assets.[95] The same procedure should adequately protect the life tenant in the trust

[94] Compare Scott, *supra* note 65, at 1026: "The trust is one of the most flexible juridical devices in our legal system. One of its chief advantages is that it can, within limits, be employed for such purposes and subject to such provisions as the settlor may choose."

[95] See 3 Scott, Trusts § 240 (2d ed. 1956); Restatement (Second), Trusts § 240 (1959).

corporation context, if the fiduciary, as controlling director, finds that the best interests of the corporation require him to limit dividends to a level which he, as trustee, deems insufficient. In such circumstances, the only solution which does not involve substantial harm to one or another of the interests involved is to subordinate the testator's design to have the shares remain in trust to the presumption preferring the life tenant over the remainderman. It is incumbent upon the testator to indicate clearly the course to be pursued by the trustee: whether to retain the stock to the possible detriment of the life tenant, or to sell the stock contrary to the original testamentary scheme. But if the testator desires to preclude this choice of evils and to limit the discretion of the fiduciary, as director, in such a manner as to prefer primarily the life tenant, his intentions should be reflected in the corporate bylaws so as to give notice of the limitation to independent interests.[96] Clearly, his failure of precise expression should not impair the interests of strangers to the testamentary scheme by the application of trust law to the corporate activities.

The conclusions drawn do not discriminate unduly against the trust as a controlling shareholder. Elsewhere in the corporate area, cases exist evidencing due regard for the interests of a minority subject to majority control.[97] The reasoning of this line of authority provides a principle by which courts may conveniently apply corporation rules to the trust corporation with a firm basis in decisional law. These cases hold that majority stockholders are in a fiduciary relationship to the minority stockholders and the corporate creditors, when the dominant interest uses its voting power to exercise actual control over the operations of the corporation.[98] It is not the power to elect directors which imposes this duty,[99] but rather the use of this power in such a way as to control directorial discretion by making the directors agents of the majority shareholders.[100] As a result of the doctrine of dominant stockholder, the controlling owner "is held to the same standard of conduct as are directors . . . ." [101] A duty of

[96] See note 53 *supra* and accompanying and following text.

[97] The terms "majority" and "minority" are used herein for convenience. The considerations are equally applicable to situations in which control is effectuated by less than a numerical majority of shares. See generally 1 BOGERT, TRUSTS & TRUSTEES § 16 (1951); ROHRLICH, LAW & PRACTICE IN CORPORATE CONTROL 96-110 (1933); Berle, *"Control" in Corporate Law*, 58 COLUM. L. REV. 1212, 1222-24 (1958).

[98] *Shareholders*: see, *e.g.*, Southern Pac. Co. v. Bogert, 250 U.S. 483 (1919); Farmers' Loan & Trust Co. v. New York & N. Ry., 150 N.Y. 410, 44 N.E. 1043 (1896); Hill v. Erwin Mills, Inc., 239 N.C. 437, 80 S.E.2d 358 (1954); *cf.* Weisbecker v. Hosiery Patents, Inc., 356 Pa. 244, 51 A.2d 811 (1947). *Creditors*: see, *e.g.*, Pepper v. Litton, 308 U.S. 295 (1939); Austrian v. Williams, 103 F. Supp. 64 (S.D.N.Y.), *rev'd on other grounds*, 198 F.2d 697 (2d Cir.), *cert. denied*, 344 U.S. 909 (1952); Dale v. Thomas H. Temple Co., 186 Tenn. 69, 208 S.W.2d 344 (1948) (alternative holding).

[99] See ROHRLICH, *op. cit. supra* note 97, at 107; Berle, *supra* note 97, at 1223.

[100] See Southern Pac. Co. v. Bogert, 250 U.S. 483, 492 (1919); Farmers' Loan & Trust Co. v. New York & N. Ry., 150 N.Y. 410, 44 N.E. 1043 (1896); ROHRLICH, *op. cit. supra* note 97, at 107; Berle, *supra* note 97, at 1223; *cf.* Weisbecker v. Hosiery Patents, Inc., 356 Pa. 244, 51 A.2d 811 (1947), which may serve to indicate the similarity of treatment of majority shareholders, officers, and directors as fiduciaries.

[101] Berle, *supra* note 97, at 1223.

loyalty to the corporation is thus placed upon such a stockholder, and self-dealing transactions will be closely scrutinized, if not prohibited.[102] The test generally applied is that of fairness;[103] the burden is on the shareholder in control to prove that advantage has not been taken of his position to the detriment of the corporation as a whole.[104] From the aspect of corporate law no reason appears why these rules should not obtain if that majority is a trust.[105] A wide use of the rule would not be objectionable to a fairminded majority and would serve to protect others having an interest in the corporation.

Priority of Remedies

These substantive determinations have relevance to procedural problems, which may be seen clearly in the context of intentional wrongdoing by the trustee-director. The dual fiduciary has distinct duties in two directions. He is bound to protect the value and prevent the loss of both the corporate assets and the trust corpus.[106] The same act or omission may constitute a breach of both duties.[107] Thus, in *In the Matter of Auditore*,[108] it was held that such conduct by a dual fiduciary gives rise to a right of action for the injury to the trust as well as a separate right of action on behalf of the injured corporation for recovery of that taken.

In the corporate action the measure of damages will be the full amount taken.[109] In an action for the benefit of the trust the loss considered is the reduction in the value of the shares as a result of the wrongdoing;

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102 See cases cited note 98 *supra*.

103 See, *e.g.*, Pepper v. Litton, 308 U.S. 295, 311 (1939); Austrian v. Williams, 103 F. Supp. 64, 75 (S.D.N.Y.), *rev'd on other grounds*, 198 F.2d 697 (2d Cir.), *cert. denied*, 344 U.S. 909 (1952); Hill v. Erwin Mills, Inc., 239 N.C. 437, 80 S.E.2d 358 (1954); Rohrlich, *op. cit. supra* note 97, at 110. In some cases the dominant shareholder is also a director, and it is not always clear in which capacity the fiduciary duty is imposed, see Booth v. Land Filling & Improvement Co., 68 N.J. Eq. 536, 59 Atl. 767 (Ch. 1905); Weisbecker v. Hosiery Patents, Inc., 356 Pa. 244, 51 A.2d 811 (1947).

104 See Pepper v. Litton, *supra* note 103; Austrian v. Williams, *supra* note 103; Hill v. Erwin Mills, Inc., *supra* note 103; Rohrlich, *op. cit. supra* note 97, at 110; *cf.* Ross v. Quinnesec Iron Mining Co., 227 Fed. 337 (6th Cir. 1915); Booth v. Land Filling & Improvement Co., *supra* note 103.

105 *But cf.* 2 Scott, Trusts § 193.2, at 1462 (2d ed. 1956): "There is no rule of public policy which precludes the owner of a majority of the shares of a corporation from creating a trust of the shares and requiring the trustee to retain the shares, thereby giving the trustee the power to control the election of directors and the ultimate control over the affairs of the corporation."

106 See 3 Bogert, Trusts & Trustees § 582 (1946); 2 Scott, Trusts § 176 (2d ed. 1956); *cf.* 3 Fletcher, Private Corporations §§ 838, 849 (perm. ed. rev. repl. 1947).

107 See In the Matter of Auditore, 249 N.Y. 335, 164 N.E. 242 (1928); General Rubber Co. v. Benedict, 215 N.Y. 18, 109 N.E. 96 (1915); In the Matter of Estate of Greenberg, 149 Misc. 275, 267 N.Y. Supp. 384 (Surr. Ct. 1933).

108 249 N.Y. 335, 164 N.E. 242 (1928).

109 See Bowers v. Male, 186 N.Y. 28, 78 N.E. 577 (1906); Corey v. Independent Ice Co., 226 Mass. 391, 393, 115 N.E. 488, 489 (1917) (dictum); 3 Fletcher, *op. cit. supra* note 106, § 1102; *cf.* Lake Harriet State Bank v. Venie, 138 Minn. 339, 346-47, 165 N.W. 225, 228-29 (1917). See generally 3 Fletcher, *op. cit. supra* note 106, §§ 1102-16.

this loss will be measured by the share of the corporate loss proportionate to the trust's holdings.[110] The corporate loss considered in the trust action is that part of the property taken which is not recoverable by the corporation.[111] It does not appear that the trust must await the outcome of the corporate action[112]—the value of the corporation's right may be treated as a question of fact in the trust action.[113] The recovery by either trust or corporation will not affect the other's right of action and in theory will not affect the measure of damages.[114] A clear distinction in effect obtains in that recovery by the corporation works to the benefit of all the beneficial owners thereof including the trust, while recovery by the trust obtains for its beneficiaries alone. It does not aid the other shareholders or the creditors that the trust recovers, and in certain cases such a recovery may result in their injury, depending upon the financial responsibility of the trustee-director and the order in which the actions are brought.

If the fiduciary has assets sufficient to meet the claims of the corporation, then the independent interests should not be injured regardless of the order of suit. If the corporation sues first, recovery will be complete. If the trust sues first, recovery theoretically should be nominal, leaving the wrongdoer capable of fully repaying the corporation. If the fiduciary is totally without funds, order of judgment is likewise immaterial to the independent interests. They can expect no recovery from such a debtor, and the fact that the trust may benefit by recovery from a surety of the trustee as such will work no harm to their interests.[115]

When the wrongdoer has assets which are insufficient to meet fully the obligation to the corporation, the order of action assumes critical significance. At present, the right of first recovery to some extent turns on the results of a race to the courthouse door. If the corporation wins the first judgment, all interests will be proportionately protected; the corporate recovery will be as complete as possible under the circumstances. Non-trust rights are again in no way injured if the trust can make an additional recovery from a surety of the trustee. However, if the trust is permitted

[110] See In the Matter of Auditore, 249 N.Y. 335, 342, 164 N.E. 242, 243 (1928); In the Matter of Estate of Greenberg, 149 Misc. 275, 277, 267 N.Y. Supp. 384, 387 (Surr. Ct. 1933); In the Matter of Estate of Gerbereux, 148 Misc. 461, 473, 266 N.Y. Supp. 134, 148 (Surr. Ct. 1933); *cf.* General Rubber Co. v. Benedict, 215 N.Y. 18, 21, 25, 109 N.E. 96, 97, 98 (1915).

[111] *Cf. id.* at 24-25, 109 N.E. at 98 (1915). The court in *Auditore* points out that if the liabilities of the corporation exceeded the assets, no harm would have been done the estate by a subsequent wrongdoing—the value of the shares could not be reduced below zero. In the Matter of Auditore, 249 N.Y. 335, 342, 164 N.E. 242, 245 (1928).

[112] *Cf.* General Rubber Co. v. Benedict, 215 N.Y. 18, 109 N.E. 96 (1915).

[113] See In the Matter of Auditore, 249 N.Y. 335, 344, 164 N.E. 242, 245 (1928); *cf.* General Rubber Co. v. Benedict, *supra* note 112.

[114] In an analogous context the "menace of a double liability" has been said to be illusory. Cardozo, J., speaking for the court in General Rubber Co. v. Benedict, 215 N.Y. 18, 26, 109 N.E. 96, 99 (1915). *But see* Note, 57 MICH. L. REV. 738, 741-42 (1959).

[115] Such was the case in In the Matter of Auditore, 249 N.Y. 335, 164 N.E. 242 (1928).

the initial recovery, the results are significantly different. In such event any recovery by the trust against the wrongdoer will further impair the wrongdoer's ability to make restitution to the corporation.

If the trust is the first to sue, the valuation of the damage to the trust must rest upon a circular analysis since its recovery depends upon the injury to the trust as a result of the corporation's inability to recover, and the corporate recovery in turn will depend on the recovery allowed the trust. The circle is inevitable in this situation since *any* recovery by the trust will reduce the corporate power of recovery. For present purposes, the significant aspect is the result that any impairment of corporate recovery in this manner will benefit the trust at the expense of the independent shareholders and creditors; and, unlike the trust, the independent shareholders do not have an action available against the wrongdoer to protect their private interests as distinguished from the corporate interests.[116] Such an excessive recovery discriminates in favor of the trust in a manner which cannot be reconciled with the spirit of the corporate rule placing controlling shareholders in a fiduciary relationship to other interests.[117]

This discussion does not demonstrate a fallacy in the theories of recovery but indicates a need for refinement in their use. It is not denied that there is need for protection of the trust interests, but these interests should be relegated to their proper sphere. Sound policy dictates that the application of the rules should recognize the interests of others when the trust has invaded the corporate field. The corporation should be permitted to sue first in order to protect these other interests. At some time subsequent to the corporate judgment, the amount of recovery to which the trust is independently entitled will be established, and the trust may thereafter proceed to judgment if it is advantageous to do so.

Conclusion

The "standard of conservatism and prudence," by which the powers of the dual fiduciary were measured in 1937, has been challenged in the intervening years by decisions which have measured his duties in terms of corporate law. But as long as cases following the old rule persist, the course of action to be followed by the trustee-director will be uncertain. In working to eliminate this confusion, the courts should seek to achieve a balance of the various conflicting interests which appear in the trust corporation. To do so, it is essential that the trust be considered as having rights equal to those of any other shareholder similarly situated and that the outer limits of strict trustee duty be drawn at the threshhold of corporate fiduciary responsibility. Beyond these limits, trust law should bow,

[116] See Tomlinson v. Bricklayers' Union, 87 Ind. 308 (1882); Wells v. Dane, 101 Me. 67, 63 Atl. 324 (1905); Smith v. Hurd, 53 Mass. (12 Met.) 371 (1847); Niles v. New York Cent. & H.R.R.R., 176 N.Y. 119, 68 N.E. 142 (1903); Beeber v. Wilson, 285 Pa. 312, 131 Atl. 854 (1926); Comment, 38 Yale L.J. 965 (1929).

[117] See notes 97-104 *supra* and accompanying text.

except in those rare instances in which its application will not infringe on independent rights.

The application of such a principle to areas considered in this Note produces the following rules:

(1) when a trustee-director is acting in the dual fiduciary role, the normal concomitants of a corporate directorship shall be the standard by which a trustee's actions are measured for purposes of ascertaining liability for breach of trust in operating the corporation;

(2) transactions between the two institutions, directly involving a conflict of the interests of trust and corporation, are to be resolved by placing the burden of proving fairness to the other party on the institution wishing to take advantage of the transaction;

(3) at any time where rights exist in both the trust and the corporation whereby independent interests in the corporation may suffer by prior exercise of the trust rights, the corporate rights are to be accorded procedural precedence.

R. E. N.